

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
<b>IT USA, INC.</b>	:	
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 2002, 2003 and 2004.	:	DETERMINATION

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DTA NOS. 823780 AND 823781

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In the Matter of the Petition	:
of	:
<b>MANIFATTURE ASSOCIATE CASHMERE USA, INC.</b>	:
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 2002, 2003 and 2004.	:

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Petitioners, IT USA, Inc., and Manifatture Associate Cashmere USA, Inc., filed petitions for redetermination of deficiencies or for refund of corporation franchise tax under Article 9A of the Tax Law for the years 2002, 2003 and 2004.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, Agency Building 1, Empire State Plaza, Albany, New York, on April 24, 2012, at 10:00 A.M., with all briefs to be submitted by September 14, 2012, which date commenced the six-month period for issuance of this determination. Petitioners appeared by Mayer Brown LLP (Alvan L. Bobrow, Esq., and Jeffrey S. Reed, Esq., of counsel). The Division of Taxation appeared by Mark F. Volk, Esq. (Jennifer L. Baldwin, Esq., of counsel).

## ***ISSUES***

I. Whether the Division of Taxation properly denied petitioners, IT USA, Inc., and Manifatture Associate Cashmere USA, Inc., the filing of combined corporation franchise tax reports for the years 2002, 2003 and 2004 with their parent corporation, IT Holding USA, Inc.

II. Whether the Division of Taxation improperly issued notices of deficiency to petitioners.

## ***FINDINGS OF FACT***

1. IT Holding SpA is an Italian clothing company based in Milan, Italy. Along with its subsidiaries, it operates a luxury goods clothing and apparel business that encompasses the design, production and distribution of fully-owned clothing and apparel labels such as Gianfranco Ferre. It also licenses labels including Just Cavalli, Galliano, C’N’C Costume National and ERMANNO Scervino. IT Holding SpA distributes its clothing and apparel through third-party stores and through directly-owned stores located in major fashion centers around the world.

2. IT Holding SpA’s initial footprint in the United States was called Fashion Avenue, Inc. (Fashion Avenue). Fashion Avenue was formed in the 1990s to distribute IT Holding SpA brands throughout the United States. It was based in New York at the offices of its accountants, Funaro & Co. Fashion Avenue’s business grew and it was necessary for Fashion Avenue to begin hiring additional personnel in the United States. Eventually its name was changed to IT USA, Inc. (IT USA). It was managed by Enrico DiMuccio.

3. As IT Holding SpA’s business grew, its management sought strategic acquisition prospects. On or about March 5, 1999, IT Holding SpA acquired a clothing and apparel company based in Italy called Manifatture Associate Cashmere SpA. Besides Italy, Manifatture Associate

Cashmere SpA also operated in a number of different countries around the world, including the United States. Its operations in the United States were housed in Manifatture Associate Cashmere USA, Inc., (MAC), which was the company's American subsidiary.

4. Management at IT Holding SpA thought it might be possible to expand further in the United States. They wanted to create a new corporation that would function as an intermediary between the Italian-based headquarters and the United States business. The new corporation would centralize all United States management and administrative functions and would eliminate any overlap of such functions among the United States businesses. The goal was to reduce overhead costs by eliminating separate management for the companies.

5. The new corporation that was formed to centralize United States management and administrative functions was called IT Holding USA, Inc. (IT Holding). It was incorporated during the last quarter of 2001. To clarify that IT USA and MAC were subordinate to IT Holding, the stock of IT USA and MAC was transferred to IT Holding on January 1, 2002. Enrico DiMuccio served as president of IT Holding, IT USA and MAC.

6. Prior to the creation of IT Holding, IT USA performed various administrative services for MAC as well as for itself. These services included monitoring inventory, customs brokering, insurance, employee benefits, budgeting, human resources, public relations, credit, receivables, factoring, real estate and strategic planning. When IT Holding was created, the employees that performed these services in IT USA were transferred to IT Holding.

7. IT Holding performed various services for IT USA and MAC. These services were generally performed from the company's commercial domicile, which was located at 85 Fifth Avenue in Manhattan. It was necessary for IT Holding to perform various services for IT USA and MAC because both subsidiaries only employed sales personnel and did not have their own

independent management or administrative employees to perform logistical functions. They were not equipped, for example, to order inventory from Italy and have it shipped to customers in the United States. Accordingly, they were reliant on IT Holding to manage their operations and their businesses. The day-to-day functions that were necessary for IT Holding to perform for IT USA and MAC included the ordering, shipping and tracking of inventory, performing credit checks, collection activity and advertising and public relations.

8. IT Holding had no inventory of its own and its activities were limited to handling management, corporate, administrative and logistical services for related corporations. It employed over a dozen individuals.

9. IT Holding had a shipping and logistics department that processed orders for IT USA's and MAC's customers. Typically, customers would examine IT USA or MAC clothing or apparel in a showroom and would place a bulk order. IT Holding's shipping and logistics department would process the order. This encompassed first arranging for inventory to be shipped from Italy to fill the order and then shipping the inventory from Italy to the United States. IT Holding contracted with a distribution company and a customs broker to facilitate such overseas shipments.

10. IT Holding used sophisticated software to track shipments and orders (e.g., orders of clothing and apparel from IT USA and MAC). The software also enabled IT Holding to monitor outstanding receivables from customers of IT USA and MAC. The software was licensed from an unrelated third party. IT Holding paid the unrelated third party for the software license and did not receive reimbursement from IT USA or MAC.

11. IT Holding had a financial controls department that handled insurance and workers compensation policies for IT USA and MAC salespeople. The same department also arranged for medical and dental plans for the IT USA and MAC salespeople.

12. IT Holding had a human resources department that was responsible for the hiring and firing of employees, including the salespeople employed by IT USA and MAC.

13. IT Holding had a public relations department that was responsible for public relations for related companies, including public relations with respect to IT USA and MAC. The public relations department also handled advertising for IT USA and MAC. At times, an invoice from a third-party firm would be issued to IT USA for advertising services, which IT USA would pay directly to the advertising firm.

14. IT Holding had a credit department that was responsible for determining whether receivables should be factored and whether customers should be permitted to make purchases using credit. The credit department was also responsible for sending out invoices and collecting receivables.

15. IT Holding rented a warehouse located in New Jersey to store IT USA and MAC merchandise that was damaged in shipping or that could not be sent to a purchaser because there was a credit hold. IT Holding did not charge IT USA or MAC to store clothing and apparel at the warehouse.

16. IT Holding organized fashion shows to display the luxury clothing and apparel of IT USA and MAC. The fashion shows would cost on average between \$500,000.00 and \$600,000.00. IT USA and MAC were not required to reimburse IT Holding for this cost.

17. There was no management services agreement, but rather a management fee schedule was prepared to document the compensation IT Holding should receive for the services it

performed for IT USA, MAC and other related companies doing business in the United States. This schedule was prepared by adding all the compensation paid to IT Holding employees and then allocating that total amount among the companies. The allocation was based on the number of estimated hours an employee of IT Holding committed to each corporation. Employees of IT Holding did not maintain records of the number of hours spent providing each service. Such a methodology assigned management fees based on cost with no markups. The management fees were never paid. The allocation of hours was based on an estimate, and no explanation was provided by petitioners as to the methodology used. No source documentation was provided to support the amounts on the management fee schedule.

18. It was intended that IT Holding would recognize no gain or loss for tax and financial accounting performances, but would rather perform management services and administrative services and be reimbursed at cost. IT Holding did receive management fee income from entities outside the combined group and did pay management fees to entities not part of the combined group. The financial statements reflect that there is no net income in IT Holding's books.

19. IT USA was incorporated in 1996. It sold luxury Italian clothing and apparel, and specialized in the wholesale distribution of women's clothing.

20. All of IT USA's stock was owned by IT Holding.

21. IT USA had no employees of its own other than salespeople. All orders of its clothing during the audit period were processed by IT Holding. IT USA made no purchases of clothing and related apparel from either IT Holding or MAC. All purchases of clothing and related apparel were made from entities not included in the combined returns.

22. MAC sold luxury Italian clothing and apparel, specializing in the wholesale and retail distribution of cashmere and related apparel. MAC and all its assets were acquired by IT Holding SpA when IT Holding SpA acquired MAC's Italian parent company.

23. One of the assets that was acquired in the transaction was a co-op located at 85 Fifth Avenue in Manhattan.

24. While MAC owned the co-op it did not lease or sublease the co-op to IT Holding or other related companies such as IT USA that occupied the co-op. It did not charge rent for use of the space at the co-op. For financial accounting purposes, rent was allocated to other companies, so other companies showed a rent expense and MAC had rent income relating to the property, but such rent was never paid and there was no formal rent agreement.

25. MAC had a showroom at the co-op that was used to display its clothing and apparel to prospective buyers. Potential customers would view this sample clothing and apparel in the showroom and would then decide whether to order in bulk based on examining the samples.

26. While MAC owned the showroom, there were no leases or subleases to other companies that also displayed clothing at the showroom.

27. MAC continually had a negative cash flow, and received money from IT USA to stay solvent and to fund its operations. No formal notes or other indicia of indebtedness were ever created to memorialize this transfer of funds. No interest on the loans was ever paid. Nor was the principal of the loans ever paid. For financial accounting purposes, the interest was accrued, but not paid.

28. All of MAC's stock was owned by IT Holding.

29. MAC had no employees of its own other than salespeople. All orders of its clothing during the audit period were processed by IT Holding. MAC made no purchases of clothing and

related apparel from either IT Holding or IT USA. All purchases of clothing and related apparel were made from entities not included in the combined returns.

30. As previously mentioned, Enrico DiMuccio was the president of IT Holding, IT USA and MAC. His responsibilities included overseeing all aspects of all of IT Holding's departments, and he was in total and sole control of the operations of IT USA and MAC, including making all the sales decisions. Mr. DiMuccio was the sole representative of the Italian parent company in the United States.

31. IT Holding, IT USA and MAC had their own checking accounts. However, the checking accounts were linked online. Mr. DiMuccio would transfer cash between the checking accounts and would move funds freely between the companies. He did not need any authorization before making these transfers between the companies, but rather would transfer funds between the companies at his discretion.

32. Fashion Avenue, later IT USA, initially operated from the offices of Funaro & Co., Inc. IT USA engaged Funaro & Co., Inc., to produce mid-year and annual financial statements for the company, prepare its tax returns and verify the third-party expenses appearing on the management fee schedule.

33. The director of audit services for Funaro & Co., Inc., worked with Fashion Avenue and then IT USA beginning in the year 2000 through the years at issue and assisted in the preparation of the financial statements for the company. According to the director, financial accounting rules require that a disclosure statement be placed in financial statements when a company is "economically dependent" on another company. In its certified financial statements prepared for IT Holding, IT USA and MAC, a disclosure was inserted to note that IT USA and MAC were economically dependent on IT Holding. The financial statements were prepared so



that IT Holding was allocated money from IT USA and MAC to pay for all expenses; accordingly, for financial accounting statement purposes IT Holding had no income or losses.

34. Funaro & Co. prepared a combined New York Franchise Tax Report for IT Holding, IT USA and MAC for the 2002, 2003 and 2004 years. On IT USA's and MAC's pro forma federal income tax returns, the entities reported numerous expenses in the "other deduction" category, such as consulting management fees, accounting and auditing fees, legal fees, bank charges, collection fees, freight fees, selling expenses, commissions and royalties. Prior to the tax year 2002, IT USA and MAC filed separate returns in New York State.

35. Following an audit of the combined reports filed by IT Holding, IT USA and MAC for the tax years 2002, 2003 and 2004, the Division of Taxation (Division) determined that the members of the combined group should be filing on a separate basis. The Division assessed the corporations as if they had filed separate entity reports.

36. During the course of the audit the Division requested documentation to support petitioners' combined filings. The Division received a one-page schedule entitled "Management Fees" for the year 2004. The schedule listed several companies, including IT USA and MAC, with percentages and dollar amounts. The schedule itself does not establish that IT USA or MAC met the 50 percent threshold of the substantial intercorporate transaction requirement.

37. In an attempt to verify the percentages included on the schedule the Division requested a copy of the management agreement between petitioners as well as a numerical analysis of how the management fees were computed (including a reconciliation to the tax returns) and any pricing study for the management services IT Holding provided to IT USA and MAC. The Division was informed that no management agreement existed between petitioners.

38. By letter dated November 21, 2007, petitioners provided a written description of the business activities and business relationship of IT Holding, IT USA and MAC in support of their combined filings.

39. By letter dated December 28, 2007, the Division requested support for petitioners' statements in their letter of November 21, 2007. The letter provided as follows:

During our phone conference on September 27, 2007, we had requested from you a quantitative analysis of the inter-company transactions between the members of the NYS as-filed combined group. Review of your correspondence, received November 28, 2007 fails to provide such analysis. In order for us to properly ascertain if the third requirement:

*Distortion Requirement-where 50% or more of the corporation's activities, income, expenses or capital are with another member of the group or with a combined or combinable group of corporations, you need to provide the following:*

- A. All Inter-company activity between IT USA and IT Holding
- B. All Inter-company activity between MAC and IT Holding
- C. All Inter-company activity between MAC and IT USA

Please note that the information requested above, must be supported by a numerical analysis and reconciled to the Federal 1120 returns filed. It also should be noted that in order to meet the 50% threshold, you must show how A, B, and C above, separately meet this requirement. Your computation **should not** reflect the combined activities of any one member with that of another member to satisfy the 50% test for the third member.

Example: Affiliate A + Affiliate B activities combined can't satisfy the 50% test for Affiliate C (not acceptable).

The activity quantified has to be **between the two** companies, not **among the three** companies.

40. The Division sent a follow-up letter dated June 10, 2008 to petitioners' new representatives. Despite numerous requests, the Division did not receive any documentation to substantiate the statements included in petitioners' November 21, 2007 letter.

41. Based on the lack of adequate documentation, as well as the information contained in petitioners' tax returns, the Division determined that petitioners did not meet the substantial intercorporate transaction requirement and further determined that petitioners should have filed on a separate basis so as to correctly reflect their income in New York.

42. Petitioners, IT USA and MAC, executed seven consents extending the period of limitations for assessment of corporation franchise tax under Article 9-A of the Tax Law that collectively extended the period in which to assess corporation franchise tax due for the years 2002, 2003 and 2004 to December 31, 2009.

43. On May 28, 2009, the Division issued to IT USA a Notice of Deficiency assessing corporation franchise tax in the amount of \$750,427.68, including penalty and interest, for the years 2002 through 2004. On June 8, 2009, the Division issued to MAC a Notice of Deficiency assessing corporation franchise tax in the amount of \$65,627.29, including penalty and interest, for the years 2002 through 2004.

44. Petitioners submitted with their brief proposed findings of fact numbered 1 through 42 pursuant to State Administrative Procedure Act § 307(1). Such proposed findings of fact have been generally accepted and incorporated herein except for proposed findings of fact 36 and 39 through 42, which are rejected as unnecessary to the determination.

45. The Division submitted with its brief proposed findings of fact numbered 1 through 50. Such proposed findings of fact have been generally accepted and incorporated herein except for proposed finding of fact 16, which is rejected as unnecessary to the determination.

#### ***CONCLUSIONS OF LAW***

A. The filing of combined reports for corporation franchise tax purposes is authorized by Tax Law § 211(former [4][a]), which, during the period at issue provided, in part, as follows:

In the discretion of the commissioner, any taxpayer, which owns or controls either directly or indirectly substantially all the capital stock of one or more other corporations, or substantially all the capital stock of which is owned or controlled either directly or indirectly by one or more other corporations[,] . . . may be required or permitted to make a report on a combined basis covering any such other corporations and setting forth such information as the commissioner may require . . . .

(4) No combined report covering any corporation not a taxpayer shall be required unless the commissioner deems such a report necessary, because of inter-company transactions or some agreement, understanding, arrangement or transactions referred to in subdivision five of this section, in order to properly to reflect the tax liability under this article.

B. Regulations promulgated under Tax Law § 211(4) provide that combined reports shall be permitted where the corporations in the group meet the capital stock requirement (20 NYCRR 6-2.2[a]), unitary business requirement (20 NYCRR 6-2.2[b]) and the “other” or “distortion” requirement (20 NYCRR 6-2.3) set forth in the regulations (*see* 20 NYCRR 6-2.1).

C. The capital stock requirement is satisfied where: (i) the taxpayer owns or controls, either directly or indirectly, substantially all of the capital stock of all the other corporations which are to be included in the combined report; or (ii) substantially all of the capital stock of the taxpayer is owned or controlled, either directly or indirectly, by other corporations which are to be included in the combined report; or (iii) substantially all of the capital stock of the taxpayer and the other corporations which are to be included in the combined report are owned or controlled, either directly or indirectly, by the same interests (20 NYCRR 6-2.2[a][1]). The term “substantially all” is defined to mean “ownership or control of 80 percent or more of the voting stock” (20 NYCRR 6-2.2[a][2]).

Since at all times relevant herein IT USA and MAC were wholly-owned subsidiaries of IT Holding, the capital stock requirement has been met (20 NYCRR 6-2.2[a]). It is noted that the Division does not contest this point.

D. The unitary business requirement and the distortion requirement are considered interrelated factors (*Matter of Autotote Limited*, Tax Appeals Tribunal, April 12, 1990). Since the Division's position is that petitioners have not satisfied the distortion requirement, a discussion of the interrelated unitary business requirement is warranted.

In deciding whether a corporation is part of a unitary business, the Division's regulations provide for a review of the following considerations: (1) whether the activities in which the corporation engages are related to the activities of the other corporations in the group; and (2) whether the corporation is engaged in the same or related lines of business as the other corporations in the group (20 NYCRR 6-2.2[b]).

The unitary business concept in federal constitutional law developed in response to the states' authority to devise formulas to accurately assess a corporation's intrastate value or income, and to limit the states' authority to tax a corporation's value or income not attributable to the taxing state (*Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 US 768 [1992]). The Tax Appeals Tribunal has applied the Supreme Court's unitary business standard to issues arising under Article 9-A of the Tax Law (*see Matter of British Land (Md.) v. Tax Appeals Tribunal*, 85 NY2d 139, 623 NYS2d 772 [1995] [allocation percentage issue arising under Tax Law § 210(8)]); *Matter of USV Pharmaceutical Corp.*, Tax Appeals Tribunal, July 16, 1992 [combination issue]).

In its decision in *Matter of British Land (Md), Ltd.*, the Tribunal summarized the unitary business principle as follows:

The constitutional prerequisite to an acceptable finding of unitary business is a flow of value (*Container Corp. of Am. v. Franchise Tax Bd.*, 463 US 159, 178). The constitution test focuses on functional integration, centralization of management and economies of scale (*Allied-Signal, Inc. v. Director, Div. of Taxation*, 112 S Ct 2251, 2252, 2261). In *Allied-Signal*, the Supreme Court

recently clarified the meaning and application of these factors by stating that these essentials could respectively be shown by: transactions not undertaken at arm's length, a management role by the parent which is grounded in its own operational expertise and operational strategy, and the fact that the corporations are engaged in the same line of business (*Allied-Signal, Inc. v. Director, Div. of Taxation, supra*, 112 S Ct 2251, 2264).

E. A review of the record herein, in light of the relevant regulatory and case authorities, compels the conclusion that petitioners were engaged in a unitary business during the years at issue within the meaning of 20 NYCRR 6-2.2(b). It is initially noted that IT Holding's activities related to the activities of IT USA and MAC as it did not sell any product of its own but merely provided services to IT USA and MAC. In addition, IT Holding, IT USA and MAC were all engaged in the same or related lines of business as IT USA and MAC sold Italian clothing and apparel and IT Holding managed an Italian clothing and apparel business and serviced corporations selling Italian clothing and apparel. The related activities of the three corporations clearly satisfy the unitary business requirements contained in the Division's regulations.

F. As noted previously, the key to a finding of a unitary business under federal constitutional law is a flow of value from one corporation to another. In the instant matter, this flow of value can be seen in numerous areas of the relationship between IT Holding and the two subsidiaries. As both IT USA and MAC did not have their own independent management or administrative employees, it was necessary for IT Holding to perform various day-to-day functions for IT USA and MAC including the ordering, shipment and tracking of inventory, credit checks, collection activity, advertising and public relations. IT Holding handled insurance and workers compensation policies for the employees of both subsidiaries, and was responsible for the hiring and firing of employees of both IT USA and MAC. In addition, IT Holding rented a warehouse that both subsidiaries used for storing merchandise and organized and financed

fashion shows to display the clothing and apparel of IT USA and MAC. IT Holding was not reimbursed for any of the costs incurred on behalf of the subsidiaries.

Also strongly indicative of a unitary business and a centralization of management was the cash management system by which funds were transferred between the corporations as well as the overall control exercised by one individual over IT Holding, IT USA and MAC. Mr. DiMuccio was the president of IT Holding, IT USA and MAC. His responsibilities included overseeing all aspects of IT Holding's departments, and he was in total control of the operations of IT USA and MAC, including making all sales decisions. He was also the sole representative of the Italian parent company in the United States. Although IT Holding, IT USA and MAC had their own checking accounts, the accounts were linked online. Mr. DiMuccio, at his discretion, would transfer cash between the checking accounts and would move funds freely between the corporations. In addition, MAC continually received money from IT USA to stay solvent and to fund its operations. Although treated as loans for accounting purposes, no formal notes were created and the principal of the loans and the interest accrued on the books of the corporations were never paid.

In sum, the record contains sufficient evidence of a unitary business. There was clearly a flow of value, centralization of management and engagement in related activities among the corporations to conclude that IT Holding, IT USA and MAC were engaged in a unitary business (*Matter of Heidelberg Eastern, Inc.*, Tax Appeals Appeals Tribunal, May 5, 1994; 20 NYCRR 6-2.2[b]).

G. The final requirement to permit or require the filing of combined reports, and the one requirement that the Division claims petitioners do not meet, is the "other" or "distortion" requirement. As previously mentioned, the unitary business test and the distortion of income test

are considered interrelated factors. Indeed it is the existence of these factors, which, taken together, constitute a unitary business, that give rise to or cause distortion of income. This interrelationship of the unitary business test and the distortion of income test in determining the appropriateness of combination is summarized as follows:

[T]he ultimate question is whether, under all of the circumstances of the intercompany relationship . . . combined reporting fulfills the statutory purpose of avoiding distortion of and more realistically portraying true income. In answering this question, no single factor is decisive (*Matter of Coleco Inds. v. State Tax Comm.*, *supra*, 92 AD2d 1009, 461 NYS2d 462) (*Matter of Standard Mfg. Co. v. Tax Commn. of State of New York*, 114 AD2d 138, 498 NYS2d 724 [1986], *affd* 69 NY2d 635, 511 NYS2d 229 [1986]).

H. Pursuant to the Division's regulations, there are two ways that distortion can be demonstrated. First, there is a presumption of distortion if "there are substantial intercorporate transactions among the corporations" (20 NYCRR 6-2.3[a]). Second, if the distortion requirement is not met because there are not substantial intercorporate transactions among the corporations, the distortion requirement can still be satisfied if "the filing of a report on a separate basis . . . results in a distortion of such taxpayer's activities, business, income or capital. . ." (20 NYCRR 6-2.3[d]). As there is no claim here by petitioners that there were substantial intercorporate transactions among IT Holding, IT USA and MAC, petitioners bear the burden of proving distortion during the period at issue. Petitioners may prove distortion by establishing that IT Holding, IT USA and MAC were not conducting their unitary business on arm's-length terms (*Matter of Silver King Broadcasting of N.J., Inc.*, Tax Appeals Tribunal, May 9, 1996).

I. Upon review of the record herein, it is concluded that petitioners have established that the filing of franchise tax reports on a separate basis would distort petitioners' true income and tax liability.



Distortion may be seen in the cash management system utilized by IT Holding, IT USA and MAC. Mr. DiMuccio had access to the linked bank accounts of the three corporations. He shifted money between these accounts on an as-needed basis with no oversight or requirement to obtain anyone else's approval. When MAC needed money, Mr. DiMuccio simply moved funds from either IT Holding's or IT USA's bank account to the MAC account. Without such a cash management system, MAC would have been forced to borrow money from unrelated third parties to meet cash flow needs. MAC benefitted from this system, but did not pay compensation for the benefit received.

The unreimbursed loans between IT USA and MAC also resulted in distortion. Although characterized as loans on the books of the corporations, there were no notes or written documentation to memorialize the loans, no stated interest rate, no repayment schedule and MAC did not pay back any interest or principal.

The centralization of management and administrative functions, coupled with the failure of IT USA and MAC to compensate IT Holding for these services, also resulted in distortion. As both IT USA and MAC did not have their own independent management or administrative employees, it was necessary for IT Holding to perform various day-to-day functions for IT USA and MAC including the ordering, shipment and tracking of inventory, credit checks, collection activity, advertising and public relations. IT Holding handled insurance and workers compensation policies for the employees of both subsidiaries, and was responsible for the hiring and firing of employees of both IT USA and MAC. In addition, IT Holding rented a warehouse that both subsidiaries used for storing merchandise and organized and financed fashion shows to display the clothing and apparel of IT USA and MAC. IT Holding was not reimbursed for any of the costs incurred on behalf of the subsidiaries.

Finally, the failure of IT Holding and IT USA to compensate MAC for the use of office and showroom space in a co-op owned by MAC created distortion. There was no rental agreement between the corporations, and although rental income was allocated to MAC and rental expenses were allocated to the related corporations, no payments were actually made.

In conclusion, it is determined that petitioners have met their burden of establishing that IT Holding, IT USA and MAC were not conducting their unitary business on arm's length terms. In particular, the cash management system, unreimbursed loans, unreimbursed services and funding provided to IT USA and MAC by IT Holding and the unreimbursed use of the MAC's co-op office and fashion show space all indicate a unitary business being conducted on non-arm's-length terms. Since petitioners have established that IT Holding, IT USA and MAC were not conducting a unitary business on arm's-length terms, the distortion requirement has been met (*Matter of Heidelberg Eastern, Inc.*; 20 NYCRR 6-2.3[f], Example 10).

J. Having met the capital stock, unitary business and distortion requirements, it is concluded that petitioners properly filed their corporation franchise tax reports on a combined basis pursuant to Tax Law § 211(4)(a) and 20 NYCRR 6-2.1.

K. Petitioners claim that sufficient proof was provided to the Division during the course of the audit to establish that the distortion requirement was met, but that the Division ignored this proof and instead issued the notices of deficiency. It is the position of petitioners that the Division, in effect, abused its discretion in requiring the filing of corporation franchise tax reports on a separate basis after receiving proof that petitioners qualified to file combined reports.

The proof referred to by petitioners is a 13-page letter dated November 21, 2007 and certified financial statements, both drafted by petitioners' accounting firm. The letter contains a detailed description of the business activities and business relationship of IT Holding, IT USA

and MAC, as well as an analysis with respect to the distortion requirement. The letter is not, however, proof that petitioners met the requirements of the combined report regulations. Had petitioners presented only the letter and certified financial statements at the hearing held in this matter, petitioners would not have met their burden of establishing that IT Holding, IT USA and MAC were not conducting their unitary business on arm's-length terms. At hearing, petitioners presented not only the November 21, 2007, but also the credible testimony of two witnesses that described in detail the business activities and business relationship of the three corporations involved herein. It was their testimony, and not the letter, that was the source of the relevant facts found herein, and it was these facts that were relied upon to reach the conclusion that petitioners should properly file on a combined basis.

In conclusion, it is determined that the Division was substantially justified in issuing the notices of deficiency given the lack of substantiation provided by petitioners during the period of the audit and it was not until the hearing that petitioners provided sufficient proof that their filing of franchise tax reports on a combined basis was proper.

L. The petitions of IT USA, Inc., and Manifatture Associate Cashmere USA, Inc., are granted, and the notices of deficiency dated May 28, 2009 and June 8, 2009 are canceled.

DATED: Albany, New York  
December 20, 2012

/s/ Thomas C. Sacca  
ADMINISTRATIVE LAW JUDGE